

Testimony
House Bill No. 78
Introduced by Rep. Keith Regier

Exhibit No. 2
Date 3/11/2013
Bill No. HB 78

By Request of the Teachers' Retirement System

Testimony in Support of HB 78
By David L. Senn, 444-3376
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Under current law, a retired member of the Teachers' Retirement System (TRS) may return to work in a TRS reportable position and is allowed to earn, without any reduction in benefits, up to the greater of one third of their average final compensation, plus CPI increases, or one third of the median average final compensation of members retiring in the previous fiscal year. Under HB 78, TRS members who terminate and retire after January 1, 2014, will be required to have a 150-day break in service before they would be eligible to return to work in a position reportable to TRS, other than as a substitute teacher who could teach up to 45 days during the 150 day period. The requirement for a 150 day break in service helps ensure compliance with pension plan qualification standards under the Internal Revenue Code and with proper tax coding of retirees' benefits. This proposal will not affect any TRS member who is already retired or members who terminate and retire on or before January 1, 2014.

Background

HB 78 was developed following an exhaustive review by TRS Tax Counsel, Ice Miller, of the IRS requirements regarding retired members returning to work in TRS reportable positions. We asked Ice Miller to review the IRS qualification and tax coding standards as applicable to retirees returning to work in TRS reportable positions and to make recommendations for reasonable plan requirements to ensure compliance with the IRS standards. Ice Miller provided an 18 page memo discussing IRS requirements for termination of employment, bona fide separation from service, and tax coding, and recommendations for ensuring compliance, including through application of a significant break in service requirement.

Qualification Issue

The IRS requires qualified plans ensure that retirement benefits are paid to members only after they have actually retired, which means that the member must have terminated employment and must have had a bona fide separation from service. Failure to do so may jeopardize the tax-qualified status of the retirement plan.

Why is qualification under Code Section 401(a) so important to TRS members, retirees, and beneficiaries? The primary advantages in TRS maintaining "tax-qualified" status are that:

- Employer contributions are not taxable to members as the contributions are made (or even when vested); taxation only occurs when plan distributions are made.
- Earnings and income are not taxed to the trust or the members (until distribution).

- Mandatory employee contributions can be made on a pre-tax basis.
- Certain favorable tax treatments may be available to members when they receive plan distributions, e.g., ability to rollover eligible distributions.

These advantages would generally not apply to a non-qualified plan.

Ice Miller's memo quotes from a recent IRS Private Letter Ruling (PLR) in which the IRS addressed how a retiree's return to work may affect the qualified status of a plan. In the PLR, the IRS stated that a retirement plan that allows an employee to retire, with the explicit understanding between the employee and the employer that the employee will return to work for that employer, would violate section 401(a) of the Code and result in disqualification of the plan.

Ice Miller's memo also discusses advice given by the IRS to Senator Sarbanes regarding an inquiry requested by a constituent of the Senator. The IRS' response discussed what constitutes a "bona fide separation from service." After stating that "bona fide separation from service" is not defined in IRS code or rule, but that relevant case law and IRS guidance describe a bona fide separation from service, the IRS indicated that a determination regarding whether there was a bona fide separation from service would be based on the specific facts and circumstances of each case. Such as, any prearranged agreement to return to work after retirement, or the required break in service.

Other Applicable TRS Law/Policy

TRS has long-standing statutory requirements for termination of employment and attainment of retired member status prior to eligibility to return to work as a working retiree of the retirement system, and imposes limitations on the earnings of working retirees. The final piece in this return to work policy to help ensure TRS is in compliance with the IRS regulations is a statutory break in service.

Tax Counsel's Recommendation for Designing a Return to Work Policy

1. Ensure Termination of Employment

TRS must ensure that a retiring member has terminated employment in all TRS-reportable positions. Termination of employment means that the employment relationship has been fully severed. The IRS takes the position that the employment relationship is not fully severed even if there is a substantial modification of the hours worked. The final Treasury Regulations state that "retirement does not include a mere reduction in hours that an employee works. It is also important to realize that the IRS may not consider the employment relationship to have been severed if the member becomes the leased employee or independent contractor of the same employer. These requirements are provide for in current law, 19-20-731, MCA.

2. Ensure There is No Pre-Arranged Agreement to Return to Work

TRS policies and procedures currently require both the retiring member and their employer to certify whether or not there is any agreement to return to work. When an agreement exists, the applicable IRS guidance is followed.

3. Reasonableness of a Break in Service Requirement

The IRS has stated repeatedly that the determination of whether there is or is not a severance from employment is to be made using a facts and circumstances test. Because applying a facts and circumstances test to each TRS member who retires would be administratively infeasible, TRS inquired of Ice Miller whether a uniformly applied break in service requirement to help ensure compliance with the IRS standards might provide a "safe harbor" for the retirement system. Ice Miller found that, based on guidance regarding the IRC Section 457 and Section 410 regulations, the IRS has indicated that a 12-month break in service period could be viewed as reasonable assurance of termination/bona fide separation from service and may serve as a safe harbor (though no express determination of a safe harbor or the parameters of a safe harbor have been issued).

Summary

Ice Miller advised that a substantial break in service requirement would assist TRS in ensuring that the IRS termination/bona fide separation from service requirements are met, and that a 150 day break in service, with a 45 day exception for substitute teachers is reasonable. (House amendments reduced the break in service from 180 days to 150 days, and increased the substitute teaching exception from 30 days to 45 days.)

Based on TRS' status as a teachers' retirement plan, a break-in-service requirement would reasonably need to be long enough to provide for a period of separation from service beyond the summer break generally taken by public school districts. The TRS Board believes a 150 day break with a 45 day exception for substitute teachers is reasonable.

We ask for your support of HB 78, and will be available to answer any questions.

**House Bill No. 78
Introduced by Rep. Keith Regier
180 Day Break in Service**

SECTION SUMMARY

Section 1. Amendments to 19-20-731. Postretirement employment limitations – cancellation and recalculation of benefits – reporting obligation of retired member.

Section 19-20-731 includes the provisions under which a retired member may return to work in a TRS reportable position; the maximum they are eligible to earn; and the consequences of earning more than the maximum amount. 19-20-731 is amended to require members applying for retirement based on a date of termination on or after January 1, 2014, to complete a break in service as set forth in New Section 2 before the retired member is eligible to return to work in a TRS reportable position.

New Section 2. Break-in-service requirements.

New Section 2 sets forth the requirement that a TRS member who terminates and retires after January 1, 2014, must have at least a 150 day break in service before the retired member is eligible to return to work in a TRS reportable position. New section 2 also includes an exception which allows a retired member to return to work as a substitute teacher for no more than 45 days during the 150-day break in service period.

Section 3. Amendments to 19-20-733. Resumption of employment by retired member – suspension of benefits.

Section 19-20-733 addresses how benefits are calculated following suspension of benefits after a retired member returns to active member status and then retires again. The relevant amendment to 19-20-733 simply provides that any resumption of employment under 19-20-733 is subject to New Section 2, as applicable.